

COMMONWEALTH OF KENTUCKY

**GOVERNOR'S BLUE RIBBON COMMISSION ON  
PUBLIC EMPLOYEES RETIREMENT SYSTEMS**

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August 28, 2007  
1:00 P.M.  
Room 154, Capitol Annex  
Frankfort, Kentucky

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**COMMISSION MEMBERS PRESENT**

Brian Crall  
CHAIRMAN

Mike Burnside  
Brad Cowgill  
Mark Birdwhistell/Chris Corbin  
William Hanes  
Gary Harbin  
Harry Moberly  
Charlie Borders  
Robert C. Brown  
John Adams  
Brent McKim  
Frank Hatfield  
Ronnie O'Nan  
Lee Jackson  
Sylvia Lovely  
Andrew R. Jacobs  
Deborah Holland Tudor  
James E. Parsons  
Rich Ornstein/Proxy for Bob Arnold  
Ryan Bridgeman/Proxy for Shawn J. Ridley  
Bryan Johnson/Proxy for David Jones

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**SUMMARY**

Minutes of Meeting  
Patty Noble  
Secretary's Office  
Finance and Administration Cabinet

## AGENDA

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Chairman Crall welcomed the members of the Blue Ribbon Commission (BRC) and took roll call. Minutes from previous BRC meeting were approved. An update from the previous Groups' meetings was requested by Chairman Crall with the following reports given:

Work Group 1 reported that they had not met in the period of time since the last meeting of the full group. The last update would still stand. It was noted that Secretary Burnside will be taking the responsibility for Work Group 1 in the future due to Brad Cowgill leaving his position.

Work Group 3 was reported by Chris Corbin. They met August 3rd where it was announced that the benefit consultant contract had been awarded to Gabriel Roeder Smith. A presentation was provided for purposes of comparison to look at benefits and differences between KTRS, KRS and the Kentucky Employees Health Plan. All that information is available on the Finance website. The next meeting is scheduled for September 25th at 2:30 p.m. in Room 154 of the Annex.

Work Group 2 was reported by Secretary Crall. He stated they heard a presentation by Bob Brown from Deferred Compensation regarding what is currently available to the state employees through KTRS, KERS or the Deferred Comp Program. A presentation was given by Gabriel Roeder Smith; they talked briefly about their initial observation of the comparison of the benefits that we currently offer to the surrounding states. A report on the legal analysis is expected sometime around September 17th. The next meeting has not been determined, but anticipated to be the last week of September.

Tom Howard, Executive Director for the Office of Financial Management gave a presentation on pension obligation bonds (POBs). The topics covered were pension obligation bonds, what states have issued such obligations, what are the benefits and concerns associated with these types of obligations, the rating agency viewpoints concerning pension obligation bonds, and the current markets for these types of securities. (POWERPOINT PRESENTATION AVAILABLE ON WEBSITE.)

Following are some questions/comments raised regarding Mr. Howard's presentation:

- QUESTION: The bond rating agency talked about the transition from soft liabilities to a hard liability. When they analyze the Commonwealth's financial status, e.g., for the Kentucky Retirement System, Cavanaugh Macdonald identified that the Systems will be out of money and will need an infusion of cash; I remember those dates, being 2013 and 2021?

- ANSWER: The health portion would be in 2013 and the pension portion in 2021.
- QUESTION: At some point, if we reach where the funds run out of money, doesn't that in the eyes of some transition that soft liability into a hard liability? The Commonwealth has to come up with the money?

ANSWER: Certainly; in the pay-go type of mode, which most pension plans have operated under, there's an assumption and that's one of the primary distinctions between public and private pensions; public entities are considered to be indefinite. Therefore, those obligations will be met over the period of time either through current set-asides or future payments and/or tax increases or other sources of revenue that may be available to the state. The Commonwealth's credit isn't predicated solely on its debt. It's also a function of its finances, its revenues, its expenditures, its fund balances. It's based on the state economy, how well we're doing, how employment is, employment growth, migration, what the levels of poverty are. They also look at governance factors like constitutional and statutory flexibility in order to balance the budget and how we can react to downturns in the economy and to plug holes when needed on a short-term basis.

- QUESTION: These bonds are not exempt from federal taxation?

ANSWER: That's correct.

- QUESTION: Is there any movement on that because that would be, an enormous savings? And I know there is some national conversation going on about that issue.

ANSWER: At the present time, these bonds would be taxable. Given the federal deficit, there's been a move to try to limit the tax-exempt status of certain types of bonds. I'm not aware of the lobby as it relates to getting an exemption for pension bonds, but there's a wholesale prohibition against taking tax-exempt bonds and investing those in higher-yielding taxable assets. There's a whole section of federal regulations that address that issue and attempt to root out the opportunities to take advantage of that.

- COMMENT: Obviously this is a national issue.

ANSWER: Absolutely, but under current law and regulation, that's not an option.

- QUESTION: Would this require state-enabling legislation?
- ANSWER: I don't believe so. If there were going to be a significant issuance of bonds, I would think it would be in our best interest to carve that out in statute. We could issue under a traditional lease appropriation type of credit. It's really no different than any of our other credits, assuming those payments were coming from the General Fund appropriations or Road Fund appropriations. Given the magnitude and the potential term of such an obligation it would be wise.
- QUESTION: This particular issue, or at least the pension bonds, is really a focus of the unfunded liability itself. What impact would it have on the annual ongoing cost or deal issues?

ANSWER: The impact is the ability. If you're able to generate savings through the pension bond structure versus the soft cost, presumably, your unfunded liability is growing at the actuarial-assumed rate of 7.75. You're saving money that you can redirect to other parts to shore up the benefits, the pension side, or for other governmental purposes; depending upon what level of funding and what the required contribution in a given period might be.

- QUESTION: One of the issues during the last General Session was discussion of pension bonds. Is there any analysis as to what impact that might have had on the pension fund and the unfunded liability or the actuary and can you share that with us?

ANSWER: I'm not really aware of those particular discussions.

COMMENT: We have that analysis done, but I think the general consensus was it didn't have a major impact on the ongoing obligation and the employer contribution rates.

- QUESTION: CERS' liability would actually be considered fully funded, yet their annual cost is a problem. If the local governments were able to band together and issue some type of debt to deal with that, do you know how that might impact their annual cost or actuary or anything?

- ANSWER: The big difference between the CERS and KERS is the contributions being paid; the true continuing cost is related to the health insurance. Looking at the pension side, you're very close to what the national pension funds look like -- 80%, somewhere in that neighborhood.
- QUESTION: If there was a significant infusion of cash, we could revisit the discount rate assumptions, and if we revisit the discount rate assumptions, that might change the unfunded liability which would then compute back to the ARC, would it not?

ANSWER: It does. The question is how much you are going to infuse.

COMMENT: I wanted to make sure the record was clear to the extent that the pension obligation bonds were significant enough; it could change the discount rate assumptions which would then change the calculation of the unfunded liability and work its way back to the ARC which is beneficial to CERS and all parties.

- QUESTION: As a lay person, I'm struggling to understand the financial aspects of this. If my thinking is correct, the state would, in essence, be choosing to issue bonds that would obligate the state to a lower interest payment on those who choose to purchase the bonds, then the state's obligation to the expected rate of return would otherwise have to pay the retirement system?

ANSWER: Right.

- QUESTION: Is there insurance that covers the risk exposure, or is that just something that the state determines that it can accept as a risk?

ANSWER: Insurance can be purchased. It's a routine matter in tax-exempt financing or governmental financing that bonds are insured and payments between parties are often insured as well.

COMMENT: The insurance is intended to protect not only us from that default, but to protect that person who buys our bonds. Knowing that the risk of default has been insured against, a bond buyer would be willing to pay a higher price for our bonds than if they didn't have the insurance.

- QUESTION: Question regarding GASB 43, 45 or OPEB; it is new and we implemented it in '06. The credit rating agencies are asking for a plan. Has there been analysis done from the credit risk when we look at the continued liabilities associated with health insurance that's still going to require that unfunded liability to grow? I can't help but

think this helps the credit agencies give some credit to the Commonwealth of Kentucky in that we've already started with an advancement of funding for our health insurance trust?

ANSWER: Right. The rating agencies understand this is a long-term workout solution; it's not immediate. They are looking for progress toward goals and the objectives may change over time as circumstance change. They are not overly concerned recognizing there's a lot of differentials between some of the numbers they are seeing reported from other states. The absolute level of the obligation did not scare them as much as what it does on a percentage of the budget. Rating agencies deal in trends... five and ten-year time horizons, not two-year periods.

- COMMENT: Another idea, instead of putting the proceeds of those issues directly into the retirement accounts, there would be something in the nature of a trust fund created; a trust fund under terms that would prohibit the Commonwealth from any active direction as to what happened to the proceeds.

ANSWER: There was a transaction that was conducted by a governmental entity out of Michigan which essentially created a VEBA (Voluntary Employee Beneficiary Association) Trust. Essentially they were taking the proceeds of a bond issue, depositing it into this VEBA irrevocable trust; as long as those investments earn enough to pay the annually required contribution on the benefit side, then, you could capture the excess if the returns on the investment were above that or the amount of the ARC were to decrease.

Rather than set the entire amount of money into the pension accounts, it's put into an irrevocable trust. The effect of that would be that the actuaries will consider that to be an asset of the pension accounts because that is its first obligation. Given the uncertainty of the future, we need not only to take into account the possibility that things could go wrong, we want to take into account the possibility that things could go well; if they did, we would want the benefit of that upturn to be shared broadly.

- QUESTION: The state quite regularly issues funds. A number of its capital projects go into the credit market; that's a way to fund a lot of capital items and things like that. Where are we as far as that goes in our debt capacity? At what point should we start being concerned about using debt as a way of solving some of our problems?

ANSWER: As of June 30th, the Commonwealth has about \$5.5 billion worth of debt outstanding; if it were all issued by June 30th of 2008, I believe the number would be about \$7.3 billion. I don't know that we will actually have all that.

We fund on an as-needed basis.

- QUESTION: I guess maybe at the next Session it would limit our ability to do other capital projects and things like that?

ANSWER: It would crowd out capital projects.

- COMMENT: We see this as a very complex situation; it is a huge problem. This Commission is going to have to make some very difficult decisions and some very detailed looking at this because it is simply unsustainable at the levels it is and where it's going. A plan that consists of nothing more than the issuance of pension obligation bonds is not a plan.
- COMMENT: This is one of the issues that will be discussed in the Work Groups. They are looking at pension benefits, insurance and then how we fund the current liability.

Mr. Mike Carter and Joe Newton from Gabriel Roeder Smith (GRS) were introduced as representing the actuarial and benefits consultant. The following comments were made during their introduction. Mr. Carter recognized the biggest issue is not the pension side, it is the health care side, and it's not one that's going to go away easy. It's a national issue.

Mr. Carter stated they would take an overview route; evaluating information, numbers and assumptions they use in terms of reasonableness and appropriateness and give their opinion on the meanings of the numbers that are given. During the project, to the extent that there are calculations that need to be made, they will be made by Cavanaugh Macdonald and reviewed by them for reasonableness and appropriateness.

Mr. Carter acknowledged that the Commonwealth has already taken some steps to correct long-term issues; the retiree medical program has already been changed for future members. It has been changed from providing an open-ended level of benefits to one of providing a more manageable level of subsidy on the retiree's Medicare--the benefit that they take to supplement Medicare. The premium that will be paying for that coverage; it's more of a subsidy in the premium than it is in the promise of a benefit; this is a major philosophical change. Another change recently made in both systems is you no longer consider the service purchase a member may make as counting towards the eligibility for the retiree medical.

The liabilities that you see calculated today would be even higher were those changes not already in place. Mr. Carter commented that they will attempt to help find other ways, other issues to look at and to help the BRC understand what others are doing and what directions that we could be following.



Following are some questions/comments that were raised:

- COMMENT: The Kentucky Retirement Systems in '03 made changes to peg it to a dollar amount for years of service. I echo your comments that, over time, that will certainly have a significant funding improvement.
- QUESTION: You've made the point that there are some things being done but they will be slow in taking effect; part of the problem with the cities and the counties is the current problem of the Baby Boomer generation. What are some of your ideas along those lines as far as looking around the country at some innovative solutions? We are quite different. CERS is quite different from the other funds in that they are local employers and employees and a very different kind of setup. The cities and the counties pay their bills on time and that's why our unfunded liability is not as large; there are some significant differences with that body of workers and retirees.

ANSWER: I believe what flexibility you will have will be affected by the input you get back in the legal opinion on what can be changed and what cannot be changed; particularly in the health care area. To the extent that there will be flexibility to do so within the Commonwealth's legal structure, plan modifications can be made in the delivery of those health care benefits; there may be some reductions in the rate of increase. We will help you look at those -- and we've done some with other states -- but we will be constrained by what your legal environment is.

- COMMENT: One of the things that we will be asking GRS to do is look at what things are being done to address the issue in other states. Which of those have applicability in the Commonwealth, given the construct of the inviolable contract, which gets us back to why that analysis is so fundamental to what we're doing going forward.
- COMMENT: The state doesn't know what the pain is because they really haven't been paying that bill on the freight. When they start doing it, it's going to have a real impact all across the state, not only on our ability to deal with our retirees, but our ability to fund roads and universities and education and everything else.

Chairman Crall requested any recommendations they would like to have the Actuarial and Benefits Consultants look at to direct those through him. He will disseminate the results out as is appropriate either to the Work Group or to the Blue Ribbon Commission.

An opportunity for the public to speak was given and the following comments are summarized:

- Mr. Les Dawson commented he was here to speak as a retiree and as a representative of the organization of Kentucky Public Retirees. He stated he was the former Commissioner of Economic Security, Secretary of Human Resources, Assistant Vice-President at the Health Sciences Center at the University of Louisville for eight years, and Secretary of Transportation. He recently retired from the University of Kentucky, having worked as Director of Internal Audit for twelve years.

He wanted to express to the Governor and the BRC appreciation for the effort to ensure the financial stability of the Kentucky Retirement Systems. Retirees have been concerned the last few years due to the under funding and were especially mindful of older retirees who have modest incomes and who experience difficulties in the many increased costs which affect their lives.

Mr. Dawson acknowledged concern with the future professionalism in state government, county government, and State Police. He is interested in the soundness of state government and the financial soundness of the retirement system. He made available the organization he represents to meet with the Commission or any member who needs additional information or opinions, and that they were very supportive of the Commission.

Chairman Crall thanked Mr. Dawson for his comments. He also acknowledged his appreciation to the members of the Commission for keeping focused on going forward in addressing the problem.

The next BRC meeting was scheduled for the week of September 24<sup>th</sup>. Chairman Crall stated the Working Groups needed to process various recommendations to give to the BRC in time to get to the Legislature before they start in '08.

Chairman Crall asked if there was anyone else wishing to speak? He made a motion to adjourn the meeting. There was no objection and the meeting was adjourned.

MEETING ADJOURNED